Who Pays the Corporate Income Tax

By BRUCE BARTLETT

Bruce Bartlett held senior policy roles in the Reagan and George H.W. Bush administrations and served on the staffs of Representatives Jack Kemp and Ron Paul. He is the author of "The Benefit and the Burden: Tax Reform – Why We Need It and What It Will Take."

The United States has had a corporate income tax since 1909, but in all the years since there is a major question about it that economists haven't been able to answer satisfactorily: who pays it? The possibility that Congress may act on corporate tax reform this year makes this a highly salient question.

Today's Economist

Perspectives from expert contributors.

The problem, of course, is that people must ultimately pay all taxes. Corporations, contrary to the views of some Republicans, are not people. They are legal entities that exist only because governments permit them to and are artificial vehicles through which sales, wages and profits flow. Hence, the actual burden of the corporate tax may fall on any of the groups that receive such flows; namely, customers, workers and shareholders, the ultimate owners of the corporation.

Probably most people assume that the corporate income tax is largely paid by consumers of its products or services. That is, they assume that although the tax is nominally levied on the corporation as a whole, in fact the burden of the tax is shifted onto customers in the form of higher prices.

All economists reject that idea. They point out that prices are set by market forces and the suppliers of goods and services aren't only C-corporations, which pay taxes on the corporate tax schedule, but also sole proprietorships, partnerships and S-corporations that are taxed under the individual income tax. Other suppliers include foreign corporations and nonprofits.

Therefore, corporations cannot raise prices to compensate for the corporate income tax because they will be undercut by businesses to which the tax does not apply. It should also be noted that the states have substantially different corporate tax regimes, including some that do not tax corporations at all, and we do not observe that prices for goods and services vary from state to state depending on its taxation of corporations.

That leaves two remaining groups that may bear the burden of the corporate tax: workers and shareholders.

In 1962, the University of Chicago economist Arnold C. Harberger, published an important article arguing that the corporate tax was borne entirely by shareholders. This was unquestionably true in the first instance; that is, when the corporate income tax was first imposed. The tax simply reduced corporate profits and had to come out of the pockets of shareholders, given that it could not be shifted onto consumers.

But as time went by, some economists argued that a substantial portion of the corporate income tax was ultimately paid by workers in the form of lower wages. This resulted because the supply of capital would shrink in order to raise the rate of return on capital. A smaller capital stock would reduce the productivity of labor and cause real wages to be lower in the long run.

Most economists now agree that the burden of the corporate income tax falls on labor to some extent, but there is disagreement over the degree. This is important because the political prospects for cutting the statutory

The first article, by a Reed College economist, Kimberly Clausing, supports the traditional idea that capital bears all of the corporate tax. She notes that large multinational corporations have a great deal of flexibility in determining where to locate production, incur costs and realize profits.

A company may borrow in one country and take the deduction for interest there, locate actual production facilities and employ workers in another country, and realize profits in a third country by transferring intellectual property such as patents there or by adjusting prices on internal sales among its foreign subsidiaries.

Moreover, Professor Clausing notes, corporate shareholders may live in many different countries, each facing a different tax regime with respect to the taxation of dividends and capital gains.

For these reasons, she argues that it is impossible for workers to bear any significant portion of the corporate tax in the form of lower wages. It all falls on capital. A second article, by Jennifer Gravelle, a Congressional Budget Office economist, agrees with this conclusion.

But a third article, by an Oxford University economist, Li Liu and a Rutgers economist, Rosanne Altshuler, argues in favor of the idea that labor bears most of the burden of the corporate tax.

They take advantage of the fact that different industries bear different tax burdens because of various provisions of the tax law, and also that concentration and competition varies among industries. They empirically examine wages among industries and conclude that labor bears about 60 percent of the corporate tax burden.

That is, a $1 increase in corporate taxes will reduce wages by about 60 cents.

Finally, four Treasury Department economists detail the method the Treasury uses to allocate the corporate tax in distribution tables. They have the advantage of access to actual corporate tax returns and far greater detail on corporate finances than available to private researchers.

The Treasury economists conclude that 82 percent of the corporate tax falls on capital and 18 percent on labor. This is very close to the methodology of the private Tax Policy Center, whose analyses are frequently cited in policy debates. It assumes that 80 percent of the corporate tax is borne by capital and 20 percent by labor.

Of course, all of these assumptions may be called into question when dealing with any specific tax reform proposal. For example, a change in depreciation allowances is mainly going to affect manufacturing companies, whereas a change in the taxes on foreign-source income will have an impact only on multinationals.

To build support for or opposition to particular changes in corporate taxation, many claims will be made about the constituencies that will benefit or be harmed. People should be aware that even the best academic economists disagree on the basics of who actually pays the corporate tax.